

Briefly describe the principal market mechanism and how it works.

Private lenders bid on loans that have previously been originated; federal government accepts highest bids. Borrower rate set by legislation; lenders bid at, above, or below par given the value they place on that revenue stream. Model encourages price competition.

Briefly describe how the proposal differs from the existing FFEL program.

The government originates loans, and private lenders bid to purchase the loans. Guarantee may or may not be retained (dropping the guarantee would reduce government's revenue from the bidding but would also reduce costs by eliminating guarantee payments). A web based technology would streamline the auctioning process. (The specifics of the auction process are elaborated below).

Briefly fill in the matrix below, where there are changes from the current program:

(same as today except where indicated)

Participant	Effect of proposal on participant's:	
	Roles	Responsibilities
Borrowers		
Lenders:		
• Originators	bid on loans (no origination function)	no origination function
• holders (includes sec. markets)	bid on loans	
• servicers		
Guarantee Agencies	limited or no role in federal guarantee against default, if there's no guarantee on loans that are sold (which is a possibility)	
States		
Schools		
Federal government:		
• Education	originate loans service loans auction loans	arrange for loan origination (through contractor?) service during in-school, grace, deferment prequalify bidders, bundle loans, conduct auction

• Treasury	possible--auction loans	possible--conduct loan auctions
• other federal agencies		
Other		

Basic operation

Who originates loans?

Government, possibly through a contractor.

How would the program assure the availability of loans to all eligible students? Would the mechanism require a "lender-of-last-resort" provision? Are any provisions made for that function, including who provides the loans, specifications for access to the loans, loan terms?

Since government performs (or is responsible for) loan origination, it would be LOLR. Might have to pay contractor more for originations in certain school types or regions, but not clear that this should be necessary.

How would loans be financed?

Lenders' funds received from bids would ultimately provide bulk of funding. Federal funds would be used to originate loans, but federal subsidy cost would be just the difference between this initial outflow and the expected revenue from the loan sales, appropriately discounted.

If the proposal involves the use of federal funds, how is the cost of the funds to the loan provider determined? If federal funds are not used, does any federal agency play a role in financing loans, for example, through federally administered asset-back securities?

Ultimately, federal funds do not finance the loans.

If private lenders originate, do they bid to win the right to originate loans?

n/a

If yes,
do bidders bid to receive a specific quantity and/or a specific set of schools, or can they originate whatever they have customers for, at the specified price?

n/a

If quantities are specified, are there any mechanisms for correction of the total if it is found to be too small, or for misallocation of the total among bidders (the reported HEAL auction problem)?

n/a

Are there set-asides for “non-competitive” bidders (those who do not formulate their own bids but are willing to accept the market price emerging from the auction) or for bidders with specific characteristics (size, location, minority ownership, source of financing or type of school connection, etc.)?

n/a

Who services the loan, and how is this determined? (Does the answer differ by in-school and in-repayment periods?) In the case of a rights auction, is it assumed that the originator determines who services?

Assuming loans are not auctioned until borrower enter repayment (so that all of a borrower’s loans can be sold as a bundle), government would service during in-school, grace, and deferment periods. Lenders purchasing loans would service (or contract for servicing) upon purchase.

Does the mechanism allow for keeping all loans for a single borrower with the same servicer?

Assuming a borrower’s loans sold as a bundle, then yes. Change of servicers likely upon loan sale (as occurs in current system). Borrower confusion regarding repayment would be mitigated generally via a unified repayment web interface that borrowers can access 24/7.

Lender and borrower rates; borrower’s terms and conditions

How is the lender rate determined? Does the mechanism set the lenders’ returns directly through a bidding process, or are returns set indirectly through a payment to (from) the government given a legislated formula already in place for the student rate and SAP?

Lender receives the rate the borrower pays. Lender bids on loans depending on valuation of the income stream that the borrower’s payments represent (with adjustments for loan balance, default likelihood, etc.). Loans could be bundled so that similar schools are within each bundle, so lenders would not have to average these characteristics across different school types. The presence of SAP, like the government guarantee, is optional. The government can take the risk of the interest rate exceeding the cap, or the lender assumes that risk and factors it into his/her bid. The agencies need to determine which model is optimal. The borrower, though, ought not to assume the risk.

If the mechanism includes a SAP, how is it determined?

No “structural” SAP--once loans purchased, lenders receive what borrowers pay.

Are the borrower's interest rate and other terms (such as repayment plans, deferments, and forbearances) set legislatively or via the proposed market mechanism?

Set legislatively.

If the borrower's rate is set via the mechanism, then

- **Specifically, how is the borrower's rate determined?**
- **How are other terms set?**
- **Are there any preset limitations on variation among students?**
- **How would the model ensure that borrowers in both Federal loan programs (FFEL and DL) receive comparable terms, conditions, and benefits?**
- **How would students and parent borrowers get information on student loan interest rates and related information? (Please specify the role ED, schools, and loan providers would play.)**

same--borrower rate not affected by mechanism

If the borrower's rate is set via legislation, is it variable? To what is it indexed?

Would need to be indexed to a CP based student interest rate because under current economic environment, the amount the government is offering to the public through T-bills will be so small that the T-bill will not longer be an instrument you can index with efficiently. The borrower's rate needs to be moved to an index with longer-term viability.

Is the borrower cost subsidized by the federal government (other than the value of a federal guaranty), e.g., is there an in-school interest subsidy?

Same (if no federal guarantee, would affect lenders' bids, but would not affect borrower's rate as set in legislation).

Would borrower rates increase or decrease as a result of the proposed changes in the program?

same

Does the borrower pay an origination fee, guaranty fee, or insurance premium? If so, how are the amounts determined and to whom are the fees paid?

same

Would the repayment period be specified in the statute? If so, how long would the repayment period be?

same

What is the impact on "consumer protection"--disclosure, entrance/exit counseling, etc.--and on loan discharges for death, disability, or bankruptcy?

Same, except not clear what the government's servicer would be expected to provide before borrower enters repayment and loans are sold.

Guarantee, defaults

Does this market mechanism model include a federal guaranty?

Maybe--would affect price lenders are willing to bid.

If yes,

- **What are the conditions of the insurance? Would these conditions include a set of loan servicing standards that could be verified/audited by the federal government on an ongoing basis?**
- **What level of lender/loan holder risk sharing is proposed? Specifically, does the guaranty remain at 98%, move to 100%, or drop to some level below 98%? And, is there any risk-sharing by other parties, e.g., schools or states?**

If yes, presumably same. Could experiment with guarantee level, due diligence, etc. to see how bids are affected.

What is the impact of the mechanism on the guaranty structure, the existing guaranty agencies, and the guaranty agency funding structure?

If yes, presumably same.

What provisions would help limit or reduce the student loan delinquency and default rates?

Unclear. The borrower web interface would better inform borrowers of their repayment options, where and to whom to send their payments, and other related matters. This should serve to limit/reduce delinquency.

If model includes loan auction/sale...

How are loans packaged--country wide or regional, homogeneous or heterogeneous by school type, etc.? Are there any other provisions for cost differences among loan types?

The web based auctioning technology would allow the government to package the loans as it sees fit – heterogeneously, homogeneously, regionally, etc. – which presumably is to optimize government return. Online analytical tools would enable the government to determine which manner of packaging loans would best optimize their returns.

Is there any provision for a minimum number of bidders?

no

Are there set-asides for “non-competitive” bidders (those who do not formulate their own bids but are willing to accept the market price emerging from the auction) or for bidders with specific characteristics (size, location, minority ownership, source of financing or type of school connection, etc.)?

no – this goes against idea of maximizing government return

Is the auction type specified or left to technical advice--e.g., uniform price or discriminatory price, actual bid price or next price below the bidder's price, or some alternative?

It would be left to technical advice, and it would depend which would maximize return.

Are whole loans sold (with purchaser determining servicer, or servicer at origination continuing to service, or some alternative), or is there securitization, in which case the servicer is determined (how?) as part of the securitization?

It would be an outright sale, perhaps with servicing to be negotiated.

Federal agency roles and responsibilities

What is the impact on ED's oversight of

- **lenders and loan holders, including: accuracy of SAP billings and invoices/ED Form 799, and loan servicing operations to ensure compliance with HEA and regulations vis-à-vis borrower provisions?**
- **guaranty agencies, including: oversight of accuracy of billings and invoices/ED Forms 1189 and 1130, impact on consumer protection aspect of GA contact with borrowers (for example, pre-claims assistance and default aversion), and compliance with HEA and regulations vis-a-vis borrower provisions?**

John Pyrovolakis model

Same, with additional responsibilities as noted in table on first page. Oversight of GAs would be moot if there is no federal guarantee. There might also be responsibilities pertaining to maintenance of the online system.

What other federal agencies would be involved in the operation of this market mechanism, and how?

Treasury--might be used to help conduct auction?

Other

Does the model incorporate both FFEL and DL, or does it leave DL as it is now? If DL remains separate, does the model establish an interest rate for DL, or would the DL interest rate have to be determined separately?

Origination, in effect, would all be through DL. The only loans the government would retain would be those that are subject to income-contingent repayment. This is because only the DOE can have access to IRS data about borrower income. If a borrower decides once their loan is sold to switch to income-contingent repayment, the government would buy it back

Would there be any additional cost or savings of the mechanism to the federal government/the taxpayer, and what would be the sources?

There would be savings generated though (i) elimination of excess yield to lenders that would be eliminated via the competitive auction and (ii) reduction of delinquency of due to better informed borrowers (which would be due to the web borrower interface). Who realizes the savings is ultimately a political decision. When the government sells its loans, it will recover enough to meet its costs, and nothing more – which means there will be significant savings to the government in total. The government can then decide what to do with this savings, be it making grants or something else.

If the mechanism leads to savings, would they accrue only to the federal government /taxpayer, or would some or all be passed on to borrowers?

Would accrue directly to government (although government could then choose to pass on to borrowers through lower rates, fees, etc.). See above answer.

Would the mechanism help to equalize net yields across school types?

Could do so, if loans were bundled in such a way as to accomplish this

Would the mechanism help to equalize net yields across lender types?

Not specifically designed to, but it could. The key point is that the auctioning technology would allow the government to bundle loans as it sees fit. It would also allow the government to use analytical tools to assess the return it would get under the various ways of bundling the loans

In general, would the mechanism help "level the playing field" between large and small lenders? More specifically, what effects would the mechanism have on the diversity of lenders, including community-based lenders, originating and secondary market lenders?

Currently, larger banks/institutions in student lending have a substantial IT/data advantage that empowers them to make more informed buy/sell decisions. There are players left out of the process that might be involved if they had the analytics to do so. The system here envisioned would provide such analytics to all parties interested in bidding on the student loan bundles, thereby enabling the smaller institutions to participate and potentially creating a more competitive bidding process. The government could also bundle loans in a way that would maximize competition (for example, by bundling together smaller loan portfolios rather than, say, billion dollar portfolios that only a limited number of institutions could bid on). So, the proposal herein described would substantially level the playing field between large and small lenders in a way that created more savings for the government.

Would income contingent repayment be available, and, if so, what federal agencies would be involved?

(see above)

What would be the effect of the mechanism on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower? (Because lenders may understandably consider the school as their real customer, lenders may not have solid data on the existing quality of service to the borrower in FFELP. When answering this question, please try where possible to provide specific data, rather than anecdotal information, on quality of service to the borrower under the existing FFELP.)

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